1812

THE NATIONAL CITY BANK OF NEW YORK EST. 1812

1942

Economic Conditions
Governmental Finance
United States Securities

New York, October, 1942

General Business Conditions

THE war effort of this country has now reached the stage, long foreseen and talked of, where a great step-up in the rate of growth of the inflationary forces is taking place. The Government's expenditures are increasing more rapidly than its tax collections, and purchases of government bonds out of current savings, while rising also, fall short by a widening margin of filling the gap. Present estimates are that in the fiscal year 1943 government spending will total $76 billions. These expenditures diffuse into all areas and sections of the economy. Unless taxes are increased still further, and new measures to stimulate saving and bond buying are taken, probably less than two-thirds of the $76 billions will be absorbed back into the Treasury. The remainder, which will have to be provided by borrowing from the banks, will total on these assumptions almost $30 billions, or one-fourth of the national income.

This projected rate of inflationary credit expansion, which is now being reached, is more than four times the rate during the fiscal year 1942, when the part of the deficit covered by bank credit was less than $7 billions and only 6½ per cent of the national income. In the year of greatest spending during the last war period, 1919, direct bank purchases of government securities represented only a little over $2 billions, or 3½ per cent of the national income, although there was in that period, to be sure, a relatively greater expansion of private bank loans. The accompanying table summarizes the Treasury financing in the two wars, showing the government spending, the extent to which the money spent was returned into the Treasury, and the remaining "gap," with estimates for 1943.

These comparisons measure the rise in the inflationary danger. The increase in bank deposits (or alternatively in money carried around in people's pockets), to result from the Treasury's operations, will give people more and more to spend. Meanwhile diversion of production from civilian to war use goes on, and the curtailment of supplies will become more apparent as accumulated stocks of goods diminish in a growing number of lines. The gap between spendable income and civilian production is the source of the inflationary pressure on prices.

Many of the people who have this added money will refrain from extravagant spending. They will save either involuntarily,—i. e., because shortages or government controls prevent them from buying the new homes, automobiles, and other goods that they would like to have,—or because it is in their own interest to save and pay off debts, or from a genuine and patriotic desire to support the war effort.

On the other hand many people, overlooking the fact that extravagant spending in any direction represents a demand for labor and resources which ought to be devoted to the war, do not see the need of economizing in places where interference with the war effort is not obvious and direct. Buyers do not see why, if they are able, they should not pay higher prices than someone else to get things they want, nor sellers why they should not receive any price that buyers are willing to pay. This applies to buyers and sellers of services and labor, as well as commodities. Moreover, the increased bank deposits, which can be drawn upon by check at any time, and the increased holdings of cur-

Treasury Financing in Two Wars
(In Billions of Dollars)

Fiscal Years ended June 30	World War I 1917	1918	1919	World War II 1941	1942	Est. 1943
National Income	42.5	51.6	59.9	82.0	102.0	120.0
Total Expenditures	2.0	12.7	18.5	13.9	34.6	76.0
Net Receipts	1.1	3.7	5.1	7.6	12.8	23.9
Non-banking Purchase of Govt. Sec.	.9	7.4	11.3	3.6	15.2	22.8
"Gap"	—	1.6	2.1	2.7	6.6	29.3

Spending and Its Absorption In Percent of National Income

	1917	1918	1919	1941	1942	Est. 1943
Govt. Spending........	4.7	24.6	30.9	16.9	33.9	63.3
Net Receipts	2.6	7.2	8.5	9.3	12.5	19.9
Non-banking Purchase of Govt.Sec.	2.1	14.3	18.9	4.4	14.9	19.0
"Gap"	—	3.1	3.5	3.3	6.5	24.4

rency, even if not immediately used, constitute a potential inflationary menace. They should be devoted to support of the war, through purchase of war bonds.

Need of Stronger Control Measures

With the inflationary pressures now being multiplied, the need of more effective measures to control them is vastly increased. It is the attitude in some quarters that the start on price control has been made in sufficient time; that prices, after all, are only now getting back to the 1926 level, which since the early days of the New Deal had been held up as desirable; that they are not rising as rapidly as during the last war. Considering, however, that the control measures debated in Congress during the past week promise to leave large loopholes through which the price-raising influences may operate, this attitude is too complacent.

Moreover, price advances in any case are consequences of inflation, the causes of which are elsewhere. It is necessary and desirable to suppress price advances, because the inflationary forces will be augmented if costs, expenditures and money income spiral upward, and because inflation works its evil mostly through prices of one kind or another. Nevertheless the controls will work in the long run only if they deal with causes as well as consequences. The outpouring of funds into the hands of the people will be so great that they will break forth into economic maladjustments in one way or another, unless diverted at the source from the stream of spending back into the Treasury.

During the past month commodity prices have been advancing. The rise in the averages has been moderate, but after five months of great stability the Bureau of Labor Statistics daily index of basic commodity prices has moved into new high ground; and the broader index of 900 wholesale prices, which also was stable through the late Spring and Summer, in the latter part of August began a new rise. The trend will bear watching.

Also, pressure is accumulating under some of the price ceilings. It is common testimony that the meat ceilings are too low in relation to the unceilinged livestock prices, making packers' margins unprofitable, and in some cases operations have been curtailed. Prices of foods generally, including milk, have been advancing at the farm level, and to some extent at the manufacturers' level, and distributors are squeezed against the March ceilings. The Office of Price Administration has these and other cases under consideration. In many instances relief will have to be given. With farm prices of oilseeds supported, a subsidy arrangement for oil crushers and shortening manufacturers, to avert breaking ceiling prices of the products, has been made; but subsidies are hidden price advances.

The War Labor Board continues to grant wage increases; and it is the rule rather than the exception to include in its awards an allowance for correcting inequalities, thereby fixing wages at higher figures than the formula of a 15 per cent advance since January 1, 1941, alone would support. This practice weakens hope for wage stabilization; for after every wage has its 15 per cent advance this reason—together with the provision for elimination of "sub-standard" wages—will remain to justify appeals for further increases. And how can "inequalities" be corrected, in the complex fabric of wage relationships, without creating fresh inequalities?

Three Inflationary Periods

This country has been through three inflationary periods, all within the experience of men who are active today, and all consisting in simplest terms of a period of debt-making and distortion of economic relations, followed by crash, debt-paying and depression. A tabulation of changes in prices, wages and other significant elements in the three periods is shown herewith:

Prices, Wages in Three Inflations

	Wages Hourly	Wages Weekly	Prices Non-Farm	Prices Farm	Cost of Living	Farm Real Estate (l)	Indust. Stock Prices
July 1914=100	(a)	(b)	(c)	(c)	(d)	(e)	(f)
July 1914	100	100	100	100	100	100	100
" 1915	101	101	103	100	100	100	128
" 1916	109	113	127	113	107	105	154
" 1917	126	129	181	189	127	114	162
" 1918	159	166	193	207	148	125	140
" 1919	180	184	202	230	167	136	196
" 1920	229	227	254	226	200	165	163
1923-1924=100	(g)	(g)	(c)	(c)	(h)	(e)	(f)
July 1925	101	100	103	113	102	96	130
" 1926	103	102	101	99	104	94	147
" 1927	105	102	95	98	103	90	172
" 1928	105	104	96	109	100	88	218
" 1929	107	107	95	108	100	88	299
Aug. 1939=100	(i)	(i)	(c)	(c)	(c)	(e)	(f)
Aug. 1939	100	100	100	100	100(k)	100	100
" 1940	105	106	103	110	100(k)	100	89
" 1941	118	129	115	141	106	101	93
" 1942	134(j)	157(j)	123	174	117	108	78

(a) Bureau Labor Statistics, annual average, non-agricultural; (b) N. Y. State, Manufacturing; (c) Bureau Labor Statistics; (d) Natl. Indust. Conference Board; (e) Dept. of Agriculture, March; (f) Standard Statistics; (g) Natl. Indust. Conference Board, Manufacturing; (h) Bureau Labor Statistics, June; (i) Bureau Labor Statistics, Manufacturing; (j) July; (k) September; (l) Value per acre.

The first period was the inflation of the last war, which was led by the great rise in commodity prices due to wartime demands and post-war reconstruction needs. This rise was accompanied, with a lag, by commensurate increases in wages, and by spectacular advances, later to prove ruinous, in real estate values, particularly of farm lands. In the subsequent crash the farmer's prices dropped, but wages and the prices of most of the things he bought remained relatively high; and most farmers who had incurred heavy debts to buy land at inflated prices were reduced to prostra-

tion. This was the source of the farm relief demands, which antedated the depression of the '30s and which persist to this day.

In the second period of inflation, in the late '20s, the farmer had small part. Nor did wage rates—although by 1927 or 1928 higher than at the 1920 peak—show extraordinary rises. This was essentially a financial inflation. The accompanying credit expansion was due to the stock market boom and to business and personal extravagance and over-borrowing, both here and abroad. Apart from the stock market the chief manifestation was in urban real estate development. The crash, starting in these areas, exposed the maladjustments dating from 1914 which the inflation had covered up. The resulting upset of price relationships and of international trade was of unexampled severity, engulfing the whole economy, not only of this country but of the world.

The third inflation is the one upon which the country has now entered. It is not duplicating either of the other inflations. Reflecting the concentration of government policy on control of prices, the overall commodity price advance and the rise in living costs so far have been less steep than during the last war. Stock market inflation is being escaped, chiefly no doubt because of the heavier taxes laid upon both corporations and individuals. Real estate values show little increase, in part because of rent controls and property taxes. Despite the high farm income, the experience of the '20s is still so vivid as to make another era of farm land speculation unlikely; in any event farm debts are being reduced, and the rise in land prices has been moderate.

The one area in which an inflationary rise greater than either during the last war or in the '20s is occurring is in wages. Since August 1939 the average hourly wage rate in the industries, according to the Bureau of Labor Statistics, has increased by 34 per cent, and the average weekly wage, reflecting longer hours and overtime rates, by 57 per cent. Precisely comparable data for the last war are not available, but an annual index of wage rates, compiled by the Bureau of Labor Statistics and included in our table, showed an increase of 26 per cent in the first three years of the war. The weekly wages earned by New York factory workers increased 29 per cent from July 1914 to July 1917.

A second area, in which the price advance has been almost as sharp as during the first three years of the last war, is in prices of farm products, up 74 per cent in this war as compared with 89 in the last. This rise started from a low level, as farm prices at the outbreak of the war were about one-third lower than in the '20s, and lower even than in 1914. They are only now recovering to the 1926 level. The advance in wage rates, on the other hand, started from an all-time high. Weekly wages are 214 per cent higher than in 1914 and 47 per cent higher than in 1926, and the work-week is shorter.

Inflation Disrupts Economic Relations

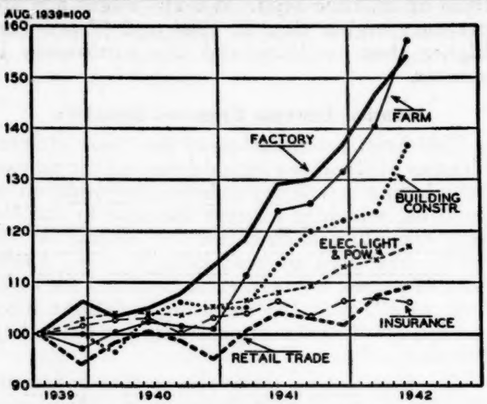
This brief examination of the main characteristics of the three periods shows that no two have been alike. The fundamental condition of inflation, which is a great increase in income and expenditure financed by expansion of credit, has been present in each case. Great rises in prices, in one area or another, are common to all. But the resulting inflations have not appeared in the same areas, nor have they behaved alike.

The first lesson, therefore, is that inflations do not exactly repeat themselves. They may be controlled by circumstances or government action in some areas, only to break out in others. The only safe control will include control of the cause, by absorbing the excess income.

The second lesson is that inflation has unequal effects in different parts of the economy and that it produces great distortions in economic relations. These distortions constitute the real catastrophe of inflation. If all prices, costs and values went up and came down together, in the same relations, the ability to carry on the exchange of goods and services would not be impaired. All business is made up of this exchange, and the fundamental requirement for conducting it is that costs and prices shall be in fair and equitable relation, so that each producer can buy the products of the others. Inflation violently disrupts these relationships.

The rise of wages causes concern because it creates such distortions. Organized labor, workers in the war industries, and farm labor are receiving great increases. In many other industries and occupations the increase has been small. This is especially true in the white collar occupations. The chart on the next page gives the course of wages since August 1939 for certain groups among which insurance and retail trade typify the white collar workers. The data are those collected by the Bureau of Labor Statistics. The increasing spread between the various wage rates is a danger, for it creates inequities in the terms of exchange between various workers.

As long as the war lasts these wage distortions may not seem important. The Government is buying much of the product of the highest paid workers, and under war conditions high costs will not stop production. The great question concerns the situation after the war. Naturally labor is as reluctant to mark wages down as it is anxious to mark them up. Will the rest of the people be able to pay the rise in wages the Government is now paying?



Weekly Wage Earnings, World War II
(Source—Bureau of Labor Statistics)

Or will they be unable to buy the goods produced at such cost? Can the products of such highly-paid workers be sold abroad? These are the sobering questions prompted by the inflation distortions, and by the showing on the record that wage rates established in booms have generally been rigid, resisting adjustment in subsequent depressions.

The third lesson from experience is that those who seem to benefit from inflation, as owners of commodities or land, or speculators in securities or property, in fact suffer most in the ensuing catastrophe,—unless of course they cash in their temporary gains and pay off their debts. Not many do that, and stop there. This should warn the groups which are trying to get more and more for themselves that for the long run they are imperiling their own security, even without regard for the others they will bring down with them in the crash.

The New Price-Wage Stabilization Proposals

As this is being written, Congress is formulating new legislation, requested by the President, intended to strengthen control over farm prices and to give the President more clear-cut powers over wages and salaries. The debate has been bitter, and the final form of the Act will not be determined until after this Letter has gone to press. Provisions already agreed upon, however, show that while in some cases the Act will permit farm price ceilings to be imposed at lower levels than the existing Price Control Act, in others—notably livestock—the permissible ceilings may be higher. At the same time it will raise the "floor" provided by government loans on staple farm commodities, by requiring loans to be made hereafter at 90 instead of 85 per cent of the calculated "parity price."

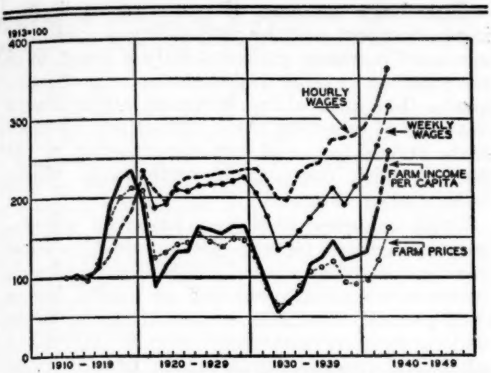
Thus the new measure in some respects is less effective than the present Act would be if all the ceilings permitted were established. It will allow all price advances to September 15 to stand, irrespective of previous ceiling provisions or the relation of prices to parity. It will allow prices on the average to move substantially above parity before ceiling provisions come fully into play. And of course the measure will be even less effective if it includes an upward revision in the calculated parity, for which the farm bloc has been contending.

Provisions for wage control are less definite, since the authority is given into the President's hands. Evidently, however, the War Labor Board's formula—allowing a 15 per cent wage increase over January 1941 to compensate for higher living costs, plus additional increases as necessary to correct inequalities and eliminate sub-standard wages—will be the guide. Because of the loopholes, plus the uncertainty whether further raises will be allowed in case of future increases in living costs, the sufficiency of this formula to stabilize wages is still to be demonstrated. Employment already exceeds the normal labor supply; workers must be recruited among people who do not usually work for a wage; and the competition for labor results in "upgrading" and other indirect as well as direct wage increases, to dissuade workers from moving on to other industries and plants. In short, rising wage trends have acquired a momentum which makes more lamentable the failure to undertake wage stabilization earlier and more firmly.

Disparity Between Farm and Factory

The controversy over the new bill, which has centered on farm demands for an upward revision of the parity price, is a fresh climax in what is essentially a conflict between farmers and factory workers. For some twenty years the case for farm relief has been based on claims of disparity between the positions of the two groups. When farm prices dropped after 1920, wage rates, relatively, did not; and despite the rise in farm prices during the past two years the farm price-wage disparity, measured in terms of relations before the first World War, has never been wider than now. It is shown by the top and bottom lines of the next chart, which diagrams the relative changes since 1914.

The high industrial wages make for resentment and friction, provoking disunity at a time when unity is essential. They are drawing labor from the farms to the industries, although food shortages are threatening and farm labor was never more needed. They have forced rapid increases in farm wages, but without solving the problem of providing more workers. This explains the unwillingness of farm bloc representatives to submit farm prices to definite freezing without providing for adjustment to future increases in farm wages.



Annual Average Farm Income Per Capita, Factory Weekly Wages, Non-Agricultural Hourly Wages, and Farm Products Prices.
1942 plottings are latest monthly figures available, except farm income which is estimated for the year. Sources: Dept. of Agriculture, Natl. Indust. Conference Board, and Bureau of Labor Statistics.

Representations such as the foregoing, however, do not cover all aspects of the situation. The supply of farm labor in last analysis will have to be augmented not by the attraction of higher farm wages, but through community effort and government policy. Farm wage increases can be countered by other employers, and competitive bidding for a limited labor supply is the essence of inflation. As for the farm-labor disparity, comparison between prices of farm products and industrial wages, on which the farm case is often based, is a comparison of unlike things. Wages are but one factor in prices, and prices of things farmers buy are relatively lower than the wages entering into their cost, because of the great increase in man-hour productivity in the industries over the years. Similarly, farm income per capita is higher than prices of farm products, because of the increase in the productivity of the farmer.

The chart also shows net farm income per capita, as computed by the U. S. Department of Agriculture. Its higher position, as related to the weekly wages of factory workers, throws a different light on the farm-factory relationship. In 1942 net farm income per capita is estimated at more than 150 per cent above the 1914 figure. Prices of things farmers buy, as reported by the Bureau of Agricultural Economics, are only 52 per cent above a 1910-14 base. The farmer is still at an income disparity with the industrial worker, relative to 1914; but he nevertheless has much the largest per capita income, both in dollars and in purchasing power, that he has ever enjoyed in his long history.

The plain fact of the matter is that both farmers and industrial workers, as groups, are probably receiving a greater share of the national income than ever in the past. Both are the seeming beneficiaries of the present inflation; its victims, on the other hand, who are caught by the rise in living costs as farm prices and wages advance, are the white collar and professional workers, charitable and philanthropic institutions, pensioners and other people with fixed incomes, unorganized labor, small business men, and all others whose taxes and living costs have risen more than their incomes.

Farmers and industrial workers are also the most numerous and dominant groups in the economy of this country. The record of past inflations shows that neither will benefit from a continuation of the inflationary spiral. On the contrary, they are inviting catastrophe for themselves, and for many other people. In their preferred position should be found a basis for a firm stabilization of the money returns of both. The answer to the demands of the farmer is a firm handling of the demands of labor, and community effort to enlarge the supply of farm workers; the answer to the demands of labor is the firm stabilization of farm prices. Both are needed. Over all is the basic need to deal with the causes of the inflation, by absorbing back into the Treasury more of the income the Government is disbursing.

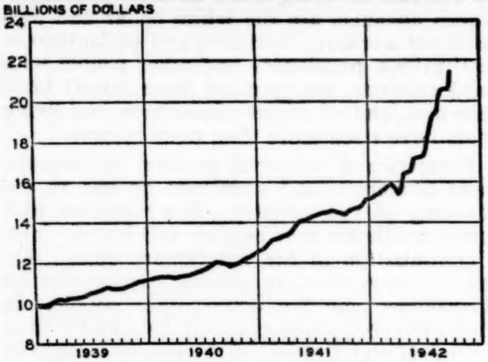
Money and Banking

With war financing now in full swing, the pace of credit expansion is accelerating rapidly. Flotations of new Treasury securities other than war savings bonds and Treasury bills reached a total of $3 billions in September and, according to an announcement by Secretary Morgenthau, will total $4 billions in October, both the largest single borrowing operations since World War I.

The new issues of September took the form of $1½ billion of 0.65 per cent, seven-months Treasury certificates and an equal amount of 1¼ per cent, 2½-year notes, and were both oversubscribed. In addition to these operations the Treasury collected the third quarterly instalment of income taxes amounting to over $2 billions and paid off $342 millions of Treasury notes maturing on the 15th.

The effect of borrowing operations of such magnitude upon the banking system is startling, as indicated by the chart on the next page covering figures for the weekly reporting member banks.

Reflecting mainly subscriptions to the new certificates, reporting bank holdings of government securities increased by $900 millions during the first three weeks of September, and on the 23rd stood $7 billions higher than at the corresponding period a year ago. Of the latter increase something like $5 billions has occurred since April. These figures are without giving effect to allotments of the new issue of $1½ billion Treasury notes on September 25 which, when included, will make the month's increase in bank holdings of "governments" still greater.



Government Security Holdings
of Weekly Reporting Member Banks

The Problem of Maintaining Reserves

The growth of bank deposits consequent upon bank purchases of government securities, coupled with the continuing rise of currency in circulation, presents the major money market problem. As deposits expand, they call for more reserves. At the same time, reserves are being reduced by the currency increase, now running at the rate of nearly $3½ billions a year. The result is a continuous drain on excess reserves, which must be made good if the money market is to be kept supplied with the funds needed to assure success of Treasury financing and avoid tightening of money rates.

In order to provide the additional funds required, the Federal Reserve Banks have bought over $1 billion of government securities in the open market since April, and have twice reduced the percentages of required reserve against deposits of member banks in the central reserve cities of New York and Chicago. The latter action followed enactment of legislation in July authorizing the Reserve Board to reduce reserve requirements in these centers independently of reserve requirements for the rest of the country; and the reductions were confined to New York and Chicago by reason of the drain imposed upon those centers by the steady flow of funds to areas where war industries are located.

The first reduction, from 26 to 24 per cent, against net demand deposits, came on August 20, and released approximately $345 millions of reserves in New York City and $70 millions in Chicago. Within less than a month — on September 14 — the second reduction, from 24 to 22 per cent, was ordered, adding about the same amounts to excess reserves as in the first case. Despite these two actions to bolster reserves, on September 23 the "excess" totals in the two main financial centers were again approaching their earlier lows, while the total of slightly over $2 billions reported for all member banks was the lowest since 1938.

The huge amount of government financing in prospect, and the probability of continued currency increase, makes it only a question of time before reserve requirements are reduced again. The authorities, however, are evidently desirous of effecting these reductions by moderate stages to avoid periodic flooding of the market with funds, and undesirable effects upon money rates.

With member bank purchases of government securities for the balance of this fiscal year estimated at around $18 billions, and with currency expansion running at a $3½ billion rate annually, indications are that the banks will be needing something over $5 billions of additional reserve funds before June 30, 1943 (assuming that the present $2 billions of excess reserves is maintained). To provide these additional funds through reduction of reserve requirements alone would mean cutting the present required reserves by roughly half. This would carry them to about the levels of 13, 10 and 7 per cent against net demand deposits in central reserve city banks, reserve city banks, and country banks respectively, and 3 per cent against time deposits, in effect before they were raised in 1936.

A substantial part of the new reserves required probably will be supplied through purchases by the Reserve Banks of government securities. To the extent that additional reserves are supplied in this way the need for lowering reserve requirements will be lessened.

The Tax Bill

The Senate Finance Committee has completed its consideration of the new tax bill, and at this writing the measure is being prepared by drafting experts for submission to the Senate.

As approved by the committee, the bill is unofficially estimated to produce around $24 billions of revenue, an increase of approximately $7 billions over present taxes, compared with $8.7 billions requested as a minimum by the Treasury, and around $6.3 voted by the House. The above total is exclusive of an additional $1.8 billion that would be collected from taxpayers, but would be returnable after the war.

In the case of individual income taxes, the committee sustained the House in raising the normal tax from 4 to 6 per cent and in increasing surtaxes from a range of 6 to 77 per cent to a range of 13 to 82 per cent. It retained the House provision lowering exemptions from $1,500 to $1,200 for married couples and from $750 to $500 for single couples, except for members of the armed forces, but lowered the credits for dependents from $400 to $300.

It recommended a 5 per cent "Victory Tax," additional to the regular income tax, to apply (with certain specified deductions) to the in-

come of all individuals in excess of $624 a year, or $12 weekly, regardless of marital status. There would be provision for post-war rebates of 25 per cent up to a maximum of $500 for a single person, 40 per cent or a maximum of $1,000 for a married couple, and 2 per cent or a maximum of $100 for each dependent; and these credits could be used currently at the taxpayer's option for payments on life insurance and debts in force before September 1, 1942, and for purchase of war bonds. The tax on wages and salaries would be deducted by the employer at the source, but otherwise would be paid in connection with the regular income tax.

In the case of the corporations, the House action raising the combined normal tax and surtax from 31 to 45 per cent was modified, and the rate fixed at 40 per cent. Excess profits tax was set at 90 per cent, as in the House bill, but with a post-war rebate and debt reduction credit of 10 per cent, and a "ceiling" of 80 per cent on the total tax (including normal tax and surtax) that any corporation would have to pay. Capital stock and declared-value excess profits taxes were eliminated.

Besides these general provisions, the Senate committee granted additional relief to certain classes of corporations. Public utilities other than railroads would be allowed to deduct preferred dividends from income subject to surtax; mining companies increasing output to meet wartime needs were given special consideration; more liberal deductions permitted to pension trusts; taxation of mutual insurance companies other than life was liberalized; and provision made for corporations having fiscal years not corresponding with calendar years.

Sales taxes, as such, were barred by the committee, and in general the House schedule of excise taxes was approved, although the tax on passenger fares was increased and a House approved tax of 5 per cent on freight charges was dropped.

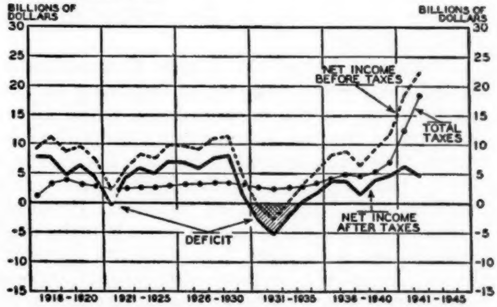
Other important changes included the vote to tax interest from future issues of state and municipal bonds, and the setting aside of the automatic increase in social security payroll taxes from 1 to 2 per cent on both employers and employes scheduled to go into effect January 1 next.

Effect of Tax Changes

In general, the effect of the Senate committee changes was to stiffen the rates on individual incomes compared with the House bill, but to lighten the severity of new levies proposed for the corporations.

The action on corporation taxes was evidently in response to testimony showing that the rates as proposed by the House would seriously weaken the financial structure of many companies and impede production. It was in accord with the sound principle that taxes should bear hardest on individual rather than corporate incomes, since it is the former that constitute the chief threat of inflation. Moreover, taxes on the corporations are taxes on the machinery of production, responsible during the war for maintenance of the flow of vital materials, and which will be looked to after the war to provide employment and supply the peace-time goods that people will be wanting. Still a third consideration is that, whereas taxation of individual incomes makes possible some distribution of the tax burden according to ability to pay, taxation of corporate income hits all shareholders — large and small — alike, and may seriously penalize many small shareholders in the event of a lowering or suspension of dividends.

The impression, widely prevalent, that the corporations generally are piling up huge profits as a result of the war is not borne out by the facts. This is shown by the accompanying diagram comparing net income of all active corporations before and after taxes, as reported by the Bureau of Internal Revenue from 1916 to 1940 inclusive, with figures for 1941 and 1942 estimated.



Net Income Before and After Taxes of All Active Corporations in the U. S.

While it is true that the net income *before* taxes has risen sharply under the expansion of war activity, by far the greater part of this increase has been siphoned off by taxes. Net *after* taxes increased in 1940 and 1941, but has fallen in 1942, and in none of the three years has been as high as was reached during the peace-time '20s.

Some exceptions to this showing have, of course, occurred. However, taking arms manufacturers alone, the figures still do not support the charges of excessive profits. As indicated by a tabulation in our last month's issue, for 125 of the largest arms contractors for which net income and tax figures were available, the net income after taxes for the first half of 1942 was 36 per cent below that of last year, and 22 per cent below the first half of 1940, before the expanded national defense program got under way.

Broadening the Tax Base

In lowering personal exemptions and credits for dependents on the regular income tax and super-imposing the Victory Tax, the tax bill takes further important steps towards the broadening of the tax base generally conceded to be necessary to reach new sources of revenue and be most effective in absorbing new purchasing power where it is being created. Changes voted in the regular income tax would, it is estimated, increase the number of taxpayers from the present 20,000,000 to 29,000,000, and addition of the Victory Tax would raise the total to around 43,000,000, or approximately 75 per cent of the total employed population. But whereas in the case of the income tax by far the larger part of the increased revenue would come from old rather than new taxpayers because of the steeply graduated surtaxes, in the case of the Victory Tax—applied at a flat rate to the income of everyone receiving more than $624 a year — the contributions exacted from incomes heretofore largely or wholly exempt would be much greater.

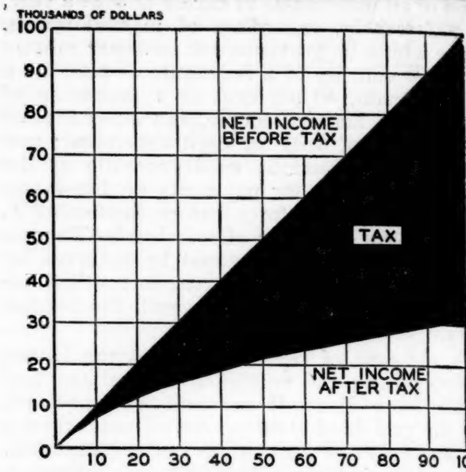
However, even with these additional levies, the amount of revenue expected is recognized as far short of what is needed to keep down the increase of debt and absorb the new purchasing power that is threatening to bring about inflation.

Testimony before the Senate Committee revealed clearly the dangers of imposing further tax burdens on the corporations, while an inspection of the tax schedules on individual incomes called for in the bill indicates with equal clarity that taxation in the higher individual brackets has about reached the limit. Probably it is not generally realized to what lengths such taxation has now gone. The diagram herewith shows the effect of proposed federal income taxes (including Victory Tax), together with present New York State income taxes, in the various income brackets from $600 to $100,000. Figures are for a married couple without dependents, and cover earned income.

It will be seen that on a $100,000 income, the amount taken by federal and state income taxes would be $69,800, leaving a net after taxes of just over $30,000. And this, of course, does not allow for real estate and miscellaneous taxes, or take account of purchase of war bonds, payment of life insurance premiums, payment of debt, and the necessity of meeting many other obligations, including contributions to educational, scientific, and charitable organizations which have always drawn a major share of their support from wealthy individuals.

A Study by the National Bureau of Economic Research

That the possibilities of raising considerable further revenue from the higher income groups and the corporations have been about exhausted is among the conclusions of a study on "Fiscal Planning for Total War," published last month by the National Bureau of Economic Research, Inc., a non-partisan organization of the highest standing and numbering among its directors representatives of industry, of labor, and of education. In a statement given to the press, the Bureau summarizes certain of the conclusions of the study as follows:



Net Incomes Before and After Federal and New York State Income Taxes in Individual Income Brackets $600 — $100,000

> A section analyzing taxes on corporations indicates that, after the present proposed rates are imposed, little more will be available for federal revenues from this source.
>
> Another section analyzes personal incomes, and estimates that in fiscal year 1943, a total of $109 billion will be paid to consumers in wages, salaries, interest and dividends.
>
> Of this sum $18 billion will be received by those having incomes of over $10,000 and the same total, $18 billion, is received by income-earners of $1750 and less. The balance of $73,000,000,000 will be received by income-earners between $1750 and $10,000.
>
> Those earning over $10,000 are already so heavily taxed that even if the government confiscated all income over $10,000 not now being taxed, not enough could be raised to pay the nation's war bills for much more than one month.
>
> On the other hand, little can be taken in taxation from the $18 billion of personal income going to those earning $1750 or less.
>
> Accordingly, there is no escaping the fact that it is from the large group earning $73,000,000,000 in 1943 — income-earners between $1750 and $10,000 a year — that the major portion of new taxes will have to be raised, if they are to be raised.

The National Bureau is doubtless right in concluding that additional taxes will have to come largely from the income groups between $1750 and $10,000. However, in view of the very large increase in industrial payrolls, it seems safe to say that the largest part of the newly created income from which the inflation threat comes is in the lower part of this range.

To reach large numbers of small taxpayers, many of whom are not familiar with making out forms, some kind of withholding tax, or deduction at the source, is essential. The Victory Tax is a tax of this character, as are the social security taxes. With the high rates now reached in the regular income tax it would be highly desirable that these levies too be put on a pay-as-you-go basis.

As a supplement to withholding taxes there would appear to be place for a general sales tax, as a tax on consumption that would reach everyone, including large numbers of persons who would escape withholding taxes by reason of not being on regular payrolls.

The Proposal to "Freeze" Social Security Taxes

The vote by the Senate Committee to suspend the automatic increase from 1 to 2 per cent in social security payroll taxes scheduled to go into effect January 1 next, was taken on motion of Senator Vandenberg of Michigan, who contended that, because of full employment and the fact that many persons are now working beyond retirement age, social security receipts are now far exceeding disbursements and social security reserves in consequence are increasing at a rate that makes unnecessary and undesirable any further increase in social security taxes. While acknowledging that some form of compulsory savings appeared "unavoidable" to help finance the war and curb inflation, the Senator stated that it should be faced "candidly and courageously" as a separate problem. "We should avoid using social security trust funds for any purposes not directly related to social security benefits, which these payroll taxpayers are presumed to buy for themselves with their assessments," he said.

Social security experts generally agree that social security taxes should be determined on the basis of needs of the social security system, and not diverted to become an instrument of financing the war deficit. The scheduled increase in tax is, however, one that was provided for before the war broke out, and as Secretary Morgenthau said in opposing the Vandenberg amendment, "sound financing requires that social security contributions be collected at the scheduled levels, especially during a period of very high incomes and employment such as these."

Science, Enterprise, and Post-War Planning

Although in time of war the chief absorbing interest is in winning the victory, nevertheless men's minds naturally turn to the question of what will happen when the war is over. Where will the war-fostered productive capacity find outlets? How can the enormous debts be supported? Is the world, victors and vanquished alike, doomed inescapably to a period of ruinous competition, impoverishment, and drastic lowering of the standard of living?

These are indeed grave questions, and the people of this country do well to give them the most earnest consideration. In general, there are two schools of thought about the kind of domestic program needed to meet this post-war emergency. One school throws the major emphasis upon government control and direction of the economy, together with a vast and more or less permanent program of government spending to supply purchasing power and provide employment. Included in this group are the adherents of the "mature economy" and "over-savings" doctrines, who even before the war were convinced that the period of America's dynamic growth had passed and that only by government intervention and "investment" in work-giving public projects can our available resources of capital and labor be fully employed. Added now to this group is a larger number of people who, though previously believers in the vitality of enterprise system, have lost faith because of the tremendous dislocations caused by the war.

The other school of thought places the main reliance upon the regenerative forces of private enterprise. To this school, government spending may serve as a cushioning element to alleviate distress and give time for recuperative forces to assert themselves, but never as the prime mover in recovery. Recoveries in the past have come by the spontaneous efforts of individuals to overcome their difficulties, each meeting his particular problem in his own way; and it is through this constant striving of individuals, aided by science and invention, that all real gains have been achieved.

In most of the discussion of post-war planning there is a singular lack of imagination as to what the enterprise system can accomplish if given a real chance to function. The defeatist who would allow the issue to go by default and leave everything to the government should be encouraged by viewing the future through the eyes of the scientist. The recent convention of the American Chemical Society has given impressive testimony from authorities of the highest standing as to recent achievements and as to the promise of further progress. An address by Dr. Charles M. A. Stine, vice-president of E. I. du Pont de Nemours & Co., Inc., gave so remarkable a survey of recent developments and of the possibilities ahead that it is deserving of the widest circulation. It goes to the heart of the present discussion, and should be an inspiration to every reader.

Dr. Stine's Address

Dr. Stine began by referring to the progress achieved since the outbreak of World War I—the development of the automobile industry and of aviation; the evolution of the "wireless" of war days to the "radio" and of the radio to television; the gigantic expansions realized by the telephone, the motion picture, and rayon;

the astounding growth of the chemical industry and of synthetics of all kinds; the revolutionary technical improvements in practically all lines of manufacture, and gains in transportation, in medicine, in public health, and in countless other directions.

Our plane of living at the outbreak of this new war, he declared, bore little resemblance to the pre-war period of a quarter-century earlier. Our clothes, our foods, our homes were different. The character of our work was changed. Our environment and thinking were those of a new age.

The Chart of the Future

Turning to the future, Dr. Stine then painted a glowing picture of what the progress can be. Already, he said, under pressure of war "our world of 1940 has become an antiquity. The inconceivables of only two years ago are today's realities. The war is compressing into the space of months developments which might have taken us half a century to realize if necessity had not forced the pace."

Continuing, he said in part:

"More than a century was consumed in bringing the crude rubber production of the world up to a million tons yearly. The United States alone is now undertaking to accomplish almost as mighty a feat in less than two years, by the manufacture of chemical rubbers from petroleum, alcohol, and coal and limestone.

"By the end of 1943, our production of aluminum will be at a rate almost seven times greater than was attained in 1939 after fifty years of intensive development. The aluminum producing capacity being created will furnish in one year metal enough to build thrice the number of passenger cars now operating on all American railroads. To produce this aluminum will require more electricity annually than was consumed in 1940 in 27 of our 48 states.

"Until a few years ago magnesium was a structural curiosity. Today almost a half-ton of it (recovered mostly from sea water) on the average is going into every American fighting plane that is built. After the war, the nation's capacity for producing this lightest of all structural metals will be more than double its aluminum output of 1939.

"Our aviation industry is establishing facilities for the manufacture in one year of almost double the number of planes it produced throughout the 37 years of its history beginning with the Wright brothers at Kitty Hawk and culminating in the defense program . . .

"The nation will emerge from this war with capacities for making plastics, synthetic fibers, nitrates, hydrocarbons, high octane gasolines, and literally scores of chemical and other raw materials on a scale that only two years ago was beyond our comprehension . . .

"In turn, steel is challenging the light metals. Low alloy steels and new modifications of the higher alloy steels, fresh from the laboratory, are bidding for expanding uses in aviation and wherever lightness and strength are requisites. In the steel industry today, technicians speak confidently of monster aircraft that will be largely steel.

"By all means watch petroleum . . . Fuels can now be made that go beyond the octane scale . . . Looking upon the situation that is indicated for after the war, the petroleum chemist now sees all existing motors as out of date . . .

New Continents of Matter

"Plastics were of sensational promise before Pearl Harbor. The newest and most versatile of plastics will be available after this war on a scale beyond all previous conception. The high pressure synthesis of ammonia, one of the major chemical exploits of the century, will have taken on an industrial status that, in terms of new producing capacity, may be comparable to the discovery of a sixth continent. The amount of fertilizer chemicals that this new capacity will be able to supply farmers will be so large that the basic trends of agriculture might be changed. And these comprise but one group of a hundred or more products stemming from this high pressure synthesis, which utilizes air, water and coal as its building blocks.

"We will have glass that is unbreakable and glass that will float, wood that won't burn, and laminations of plastics and wood that will compete with the structural metals. Hosiery derived from air, water and coal, a wonder of pre-war days, is but the forerunner of many innovations from the same source, ranging from shoes that contain no leather and window screens that contain no wire, to machinery bearings that contain no metal . . .

"We will have at our command ten, fifty, a hundred times what we had before, chiefly of new materials . . .

Automobiles and Housing

"Fuels and metals and plastics are now ready to complete the revolution in transportation begun early in the century. The automobile manufacturer's slate has been wiped clean for a fresh start, which should result in new cars that will be of incredible efficiency judged by present standards. Since motor car production stopped, the shiny new models that are now gathering dust in dealers' storerooms have aged, technically, at least two decades. We are now in the 1960s of motor cars, as measured by the old pace of development.

"Sealed cooling systems, proved on large scale by aviation, may end in the post-war car the nuisance of adding water to radiators.

Weights may be half what they are now, power will be up, and fuels may yield 50 miles to the gallon, or better.

"In housing, prefabricated sections, which easily may be handled by two men, will permit flexibility in architectural designs. New insulating materials, making possible light walls that will be several times as efficient as heavy masonry ones, will allow the use of revolutionary structural principles.

"Plywood, plastics, rustless steels, non-ferrous alloys, various types of composition board, fire-resistant woods, ceramics, and synthetic finishes of lasting durability will be employed in profusion. For example, stainless steel is indicated as a common roofing material of the future. It will last as long as the house and require no maintenance. Lighting will be automatic, governed by electric "eyes" sensitive to outside variations in the daylight. Air-conditioning units will filter out the pollens of hay fever and asthma . . . "

Dr. Stine went on to discuss many other changes, including developments in medicine which he said might ultimately "outweigh by many times even the staggering losses of the world-wide conflagration."

Fear of Change Scouted

"No doubt," he said, "some will be alarmed over the possible displacement of old materials and old industries. Changes of a drastic nature are inevitable but they seldom result in the hardships that the timid predict. More wrought iron is being used in the world today than when wrought iron occupied the province now held by steel. The horse and buggy vanished, but the buggy manufacturers who were alert rose to new affluence with the motor car. The coal-tar dyes ended the centuries-long reign of natural dyestuffs, but the dyestuffs industry has grown to many times its former size, and spawned a dozen new industries in addition."

In conclusion, Dr. Stine referred to the four freedoms of President Roosevelt — freedom from want and freedom from fear, freedom of speech and freedom of religion—but added a fifth freedom mentioned by Herbert Hoover as also mandatory in the victory—freedom of economic enterprise.

The Kind of Post-War Planning Needed

Such are the achievements and promise of the system of individual enterprise. Who says that this system has failed, that the day of great discoveries has passed, and that progress is slowing down!

To realize the promise, victory in the war, of course, is the first essential. But there is need for more. These things will not "just happen": there must be an environment in which private enterprise may flourish; there must be capital for experiment and development; there must be encouragement of the enterprise spirit and adequate incentive to risk and strive.

The scientist or inventor who makes the new discoveries usually does not put them into effect. This usually is done through some form of business organization — generally a corporation. If it is a new enterprise some one must supply the money. If it is an established business, there must be adequate earnings or reserves, or new capital must be obtainable in the markets. But if taxes are too high upon individuals who have surplus funds to invest, or if business concerns are not permitted to make and retain sufficient earnings after taxes to finance development or attract outside capital, progress will be held back and we will kill the goose that lays the golden eggs.

There is need for more emphasis upon making the enterprise system work than upon making it over. To a large extent progress depends merely upon clearing the road. It depends upon modification of unnecessarily restrictive laws, such as the Securities Act which impedes the raising of new capital, and upon correction of injustices such as are embodied in the National Labor Relations Act which defines and prohibits unfair labor practices on the part of employers, but ignores unfair practices on the part of employes. It depends upon soft-pedaling the persistent, confidence-destroying sniping at business and business management for political purposes.

All this suggests the kind of post-war planning needed. Let the test of any plan be whether it will help or hinder the setting of private capital in motion. No plan, however, can work without recognition by all groups in the community of an obligation to make it work. The statement frequently made that society will no longer tolerate unemployment is as vain as would be the statement that society will not longer tolerate disease. The economic system is a vast cooperative organization, dependent for its proper functioning upon a fair exchange of goods and services among its members. If individual groups are immoderate in their demands, no power on earth can prevent the system from falling into disorder. No program of public spending alone can possibly be adequate, but could only lead to bankruptcy or suppression of the private enterprise system, or both.

On the other hand, if the developments envisioned by the scientists can be realized, the new wealth produced will make good the ravages of war, render the debts supportable, and bring about an increase, rather than a decrease, in the standard of living.

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